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Economic Conditions
Government Finance

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General Business Conditions

THE feeling that inflationary forces were again taking charge of the business situation, which was spreading earlier in the Summer, has been decidedly tempered by the British exchange crisis. During the past several months commentators on the outlook, including these Letters, have warned that the export balance of the United States was running at an abnormal rate which was unlikely to be maintained. The events in Great Britain, described on subsequent pages, have dramatically put the country on notice that this is the case.

It is of course true that in so far as the dollars paid out by the British have merely been transferred to other countries, which will now be able to buy American goods and services with them, there has been no loss of markets to this country in the aggregate. A good part of the "run on sterling" after July 15 was of this nature, — a shifting of dollars from the British Treasury to other people. But the long-run implications for American trade are plain. The British will have to reduce their import balance, which will mean a cut in buying here and elsewhere. Other countries selling to Great Britain will have to take payment in sterling funds not convertible into dollars. They will be able to use these funds to buy in sterling countries. but not in the United States. Their desire to sell in this country, to obtain dollars, will be stronger than ever.

Recent developments indicate that export shrinkage has already begun. Exports in June showed the first month-to-month decline of any size in six months, with a drop of $180 million below the May level. Many countries, particularly in South America, have recently tightened import restrictions. In some cases they have prohibited certain imports entirely; in others they are reducing the amounts for which import licenses will be issued, or moving more items from essential to non-essential classifications, making them subject to greater restriction.

Effects of Export Shrinkage

Now that the country is facing the expected decline in exports, the problem is to determine its effects on the domestic outlook. Merchandise exports averaged $1,260 million monthly in the first half of 1947. They have been one of the important props of the huge volume of business, and particularly of the markets for farm products, during this year.

In the first half of the year the item "net exports of goods and services" in the nation's economic budget, as presented in the Midyear Economic Report of the President, stood at $10 billion annual rate. This is a huge figure. It represented only about 4½ per cent of the total output of goods and services ("gross national product"), but such a percentage taken by itself unduly minimizes the weight of exports in the country's business. Exports provide employment and purchasing power indirectly as well as directly. They take potential surpluses off domestic

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markets, and they have a stimulating influence on business sentiment through the support they give to prices and domestic trade. Some industries and some branches of agriculture depend upon them to a far greater degree than is suggested by overall or average figures. A shrinkage of markets in these lines would affect not only their current operations, but plans for capital expenditures.

The Sustaining Influences

Nevertheless, pessimistic interpretations of the outlook may be overdone. In the first place, to conclude that recent developments portend an early and violent, rather than a gradual and moderate, contraction of our exports would be premature. Many countries hold substantial balances of dollars and gold, as described in articles in the July and August issues of this Letter. Unexpended proceeds of credits previously granted are still considerable, new gold produced will largely come our way, and additional loans or grants of funds that will be spent here may be available through existing authorizations and institutions, notably the International Bank. Moreover, work on programs to implement Secretary Marshall's proposals is still in the beginning stages, and what may grow out of it cannot now be foreseen.

The second point is that the business of this country is in position to withstand a decline in exports, perhaps better than at any other time in its history. This statement does not imply that a drop would be welcomed, for the world needs our goods, particularly productive equipment to assist reconstruction and rehabilitation. But from the narrower viewpoint, it is nevertheless true that exports have been an inflationary influence, and will continue to be so if the trade continues so drastically one-sided. When goods are shipped out of the country the purchasing power created by their production and sale remains in the country, and when we ship more goods than we receive the total purchasing power increases relative to the supply of goods.

Export demands have prolonged and intensified shortages and boosted prices. Conversely, relaxation of the export pressure will produce a more normal and orderly situation. Domestic needs will be better supplied, in cases where shortages are still present.

It follows that domestic demand can take up at least part of the slack that may come in exports. In automobiles, for example, it is plain that the cars now being sold abroad could all be sold at home, with no effect on automobile market conditions except a possible decline in the premiums above list prices which so many people have to pay, in one way or another, to get new cars. If less steel were exported, production of automobiles and many other articles would be larger. We repeat that we should not welcome a decline in our exports of the commodities which the world needs so acutely. But realistic appraisal requires an understanding, first, that such a development would have its blessings as well as its evils; and, second, that possibilities of expansion in domestic buying exist in some lines, to offset a drop in foreign purchases.

What the effects on sentiment may be if exports grow progressively smaller is hard to foresee. If developments should lead to cancellation of plant expansion and improvement programs, to general bearishness, deferment of buying and declining prices, the direct effects would be multiplied. For the present however, this would be taking too gloomy a view.

The Domestic Situation

In the domestic situation the supporting influences, in the way of accumulated orders and demands, and record-breaking employment and income, continue strong. Merchandise buyers during the past few months have shown more readiness to pay the prices asked in the markets, despite their uncertainty as to what the public reaction will be when the goods are offered across the counters. Apparel manufacturers are under pressure for shipments. The shoe factories and soft woolen mills are stepping up operations after some months of curtailment, and cotton mills have orders in many lines for months ahead. Thus it seems evident that the soft goods industries will give more support to employment and purchasing power this Fall than many people considered likely a few months ago.

The automobile and steel manufacturers continue under pressure for all they can produce, and with most of the capital goods industries still having heavy backlogs and construction activity holding better than the pessimists of last Spring expected, the likelihood that industrial production during the Fall will stay fairly close to the Spring peak is now generally accepted. For July the Federal Reserve Board's industrial production index stood at 178 (1935-39=100), against the March peak of 190, but July was the month of the coal and steel shutdowns. For the early future, improvement rather than retrogression from the 178 figure is to be expected.

This much of the detail of business news makes up a picture of sustained momentum. On the other hand, the current reports also include many cases of declining unfilled orders and some

of curtailed operations, as in the brass mills of the Connecticut Valley. Department store dollar sales in recent weeks have run below last year, even though prices are higher.

In some parts of the domestic economy the workings of inflation have continued plain, although price movements show irregularity. Adjustments to the advances in coal and steel prices, and in wage rates, have continued during August, with general markups in automobiles and a good many advances in manufactured goods. The "other than farm products and foods" component of the Bureau of Labor Statistics wholesale price index has had six weeks of unbroken advance since the coal wage settlement. Confirmation that the corn crop is short, and that prices of feed, meat and dairy products will be correspondingly high, indicates that little if any relief from the high cost of living is in sight. Many people therefore see the situation dominated by wage demands and by an upward price spiral, to which they see no certain or predictable end.

This is the chief reason for concern. Belief that prices are moving only one way may be temporarily stimulating, but if it leads to overbuying reaction and losses will follow. People who are inclined to count too confidently upon a continuing price rise should give heed to the warnings conveyed by the export developments, as well as to the indications of filling pipelines at home. What is needed above all, to strengthen the situation against recessive influences, is higher man-hour output to validate the wage rises already given. It is notable that bituminous coal output, since the wage increase, has been running steadily below the pre-strike figures, by something like a million tons a week. Our reports say that more men are employed, but that output per man-day has declined approximately in proportion to the reduction of hours; in other words, the shorter day has brought no equivalent increase in man-hour production to compensate for the wage advance. The more people — whether labor or management — try to take for themselves out of this period of full employment, without regard for the general welfare, for the level of costs and the balance in prices and incomes, the more surely will the period be shortened; and the more vulnerable the domestic situation will be to shock from abroad.

British Balance of Payments Crisis

The crisis in the British balance of payments situation, the crucial problem of Britain's economy since the war, had been in the making for some time. It came to a head with unexpected suddenness in the heavy withdrawals of dollars from the American credit over the past two months. The crisis has already brought about a series of drastic measures designed to reduce the gap in the balance of payments, a freezing of the remainder of the American loan, and a partial suspension of the convertibility of currently-earned pound sterling.

Concern over the deterioration of Britain's balance of payments position has been growing ever since the fuel crisis last Winter, and was accentuated by the stepping up in the rate of withdrawals from the American credit during the Winter and Spring. It was becoming more and more evident that — barring additional outside aid — more drastic measures to conserve dollars would be required. Still the situation was not thought to be immediately critical. For over six months the British authorities had been working out a series of exchange agreements with other countries looking towards restoration of sterling convertibility on current transactions by July 15, as called for by the terms of the Anglo-American loan, and apparently London was viewing the approach of that date with no great apprehension. In fact, July 15 came and went with no outward sign of disturbance.

However, when July figures on the use of the American loan were given out they revealed that withdrawals, which averaged $167 million a month during the first quarter of 1947 and $237 million during the second, had soared to $700 million for that month alone. Hope was expressed for a falling off in August, but actually — with the discussions in the press and the debates in Parliament — the rate of withdrawals increased. In the single week of August 18 they reached $237 million. On August 20 came the announcement of limitation on sterling convertibility and of the temporary "freeze" on the loan. The following table, giving the monthly rate of drawings on the loan, together with amounts actually spent, traces the development of the crisis:

Monthly Rate of Withdrawals and Actual Disbursements under Anglo-American Credit
(In Millions of Dollars)

Period	Withdrawals	Actually Spent
1946, 3rd Quarter, monthly average	$133	$ 70
4th " " "	67	120
1947, January	200	137
February	100	224
March	200	223
April	450	307
May	200	334
June	300	308
July	700	538
August	600	—

On August 20 there remained of the American credit but a meagre $400 million uncommitted out of the $3¾ billion that was granted to Britain just a little over a year ago and which was hoped

would give Britain a breathing spell of four years in which to restore her balance of international payments. At the same time, Britain has drawn all but $500 million of the Canadian loan of $1,250 million, also granted last year. Britain's present official gold and dollar reserves amount to $2,400 million, but these reserves, as the Chancellor pointed out, "are also the reserves of the whole sterling area."

The Gap in the Balance of Payments

To what extent has the widened gap in Britain's current account transactions dissipated her dollar resources so far ahead of schedule? When the official "Economic Survey for 1947" was published early this year, it was estimated on the basis of the outlook before the fuel crisis that the deficit in Britain's overall current transactions in 1947 would be around £350 million ($1,400 million). Since then the gap has been widening and unofficial estimates (made prior to recent measures to reduce imports) placed the prospective deficit for 1947 at £550-600 million ($2,200-2,400 million). The deficit in the overall current transactions in 1946 was around £400 million and in 1938 about £70 million.

The situation is made more critical by the fact that a considerable part of what other countries owe to Great Britain cannot be collected at present either in goods or "hard" currencies. Nearly 80 per cent of exports are shipped to the sterling area or the countries with inconvertible currencies. On the other hand, half of Britain's payments for imports must be made to the "hard" currency countries, such as the United States, Canada and Latin America. On the basis of figures for the first six months, given by the Prime Minister and reproduced in the table below, the dollar deficit of Britain and the sterling area was running at the annual rate of about $3.2 billion.

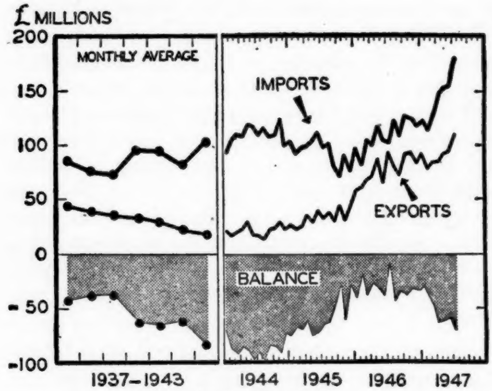
Britain's Dollar Deficit, January-June 1947
(In Millions of Dollars)

Deficit in Britain's trade with the United States	$ 704
Dollar expenditures on German account	116
Deficit in Britain's trade with other Western Hemisphere	472
Sterling area purchases in the United States, net	232
Sterling area purchases in Western Hemisphere, net	40
Purchases by European countries in dollar area, net	56
Total	$1,620

Causes of the Deterioration

One reason for the deterioration of the balance of payments was the rise of prices in the supply markets. With prices in this country up 30 per cent on the average during the year ended June 1947, the purchasing power of the dollars in the loan was reduced substantially.

A second and probably more important reason was the Winter fuel crisis and raw material shortages. A large segment of British industry was paralyzed, causing a heavy loss in production. While, as the accompanying diagram shows, exports have made a good recovery from the Winter low, the whole program was inevitably retarded and the trade deficit, which had shown marked improvement during 1946, shot back this year to levels prevailing at the end of the war. On a volume basis, exports for the second quarter of 1947 were still considerably below those for the last quarter of 1946.



British Foreign Trade
(Millions of Pounds)

A third reason for rapid exhaustion of the loan has been heavier than expected expenditures in occupied countries. It was stated that $50 million of the heavy July withdrawals from the U. S. loan was to feed the Germans.

Still a fourth reason may have been the inflationary pressures in the United Kingdom, the effects of which are touched upon in later paragraphs.

Pound Convertibility Effort Premature

But while the deteriorated balance in goods and service transactions was important, it could not alone account for the spectacular inroads of the past two months upon Britain's dollar resources. It is now clear that the attempt to make sterling arising from current transactions freely convertible was premature. In granting convertibility the British Government had to assume that other countries would cooperate in maintaining a convertible system by carrying a portion of their free funds in London. But evidently the pressures have been too great.

In the first place, other countries wanting dollars and holding convertible sterling were under strong temptation to use such sterling not immediately needed for purchase of British goods to satisfy their dollar requirements. In other words, making the pound convertible had the effect of centering upon sterling pressures resulting

from dollar shortages developing in other countries.

The second reason is psychological. Holders of sterling have lacked confidence in the ability of Britain to maintain convertibility, and those who could substantiate a claim to transferable sterling have made haste to get out while they could, perhaps even converting into dollars, sterling that might have to be reacquired within a short period. The fact that the newly-accorded right of convertibility applied not only to sterling from current transactions, but also to some part of past accumulations was also an influence.

Under these circumstances Great Britain has taken the logical step to halt the drain and prevent the exhaustion of dollar resources by clamping down on convertibility and suspending temporarily further drafts on the dollar loan.

This does not mean that she has gone all the way back to wartime restrictions. Countries with which "transferable account" arrangements had been made may continue to exchange currently earned sterling between themselves. For the time being, however, they may not freely convert their sterling holdings into dollars by transferring them to the American account group which includes the United States, the Philippines and certain Latin American countries. Sterling in American accounts, however, remains freely convertible as before. Britain's expenditures in American account countries are, of course, bound to be cut down drastically.

The British Government Program

In an endeavor to reduce the deficit in the balance of payments, and, in the words of Prime Minister Attlee, "stand on our own legs as soon as possible", the British Government has asked the people to support a program of severer austerity and harder work. The Government has been granted authority to revive many of the wartime controls over employment, capital investment, and industrial management. Workers seeking jobs will have to find employment through the government labor exchanges and thus be directed into essential industries. The Government will have power to intervene where management is "avoidably inefficient" or "displays lack of will to serve the nation's best interests."

Targets for output in basic industries, such as coal-mining and steel, have been increased. While the principle of the 5-day week in coal-mining will be preserved, mine-workers are to be asked to contribute a half-hour extra work a day, or its equivalent, as an "emergency measure for a limited period." In agriculture, the goal is a 20 per cent increase in home food output by 1951-52.

In the critical foreign trade field, the target for exports, which had been set at 140 per cent of 1938 volume by the end of 1947, is now recognized as unattainable. The aim now is to reach that target by the middle of 1948 and to reach 150 per cent of 1938 volume by the end of next year. The Government plans new restrictions upon imports, notably in oil, films, lumber, and miscellaneous consumer goods, with concentration of food purchases as far as possible in sterling area countries. Meat rations, already low, will be pared further, restaurant meals cut, and drastic restrictions imposed on motoring and foreign travel.

Defense forces abroad are to be reduced, and arrangements sought to eliminate the spending of dollars for feeding the population of the British zone in Germany.

All this means for the British people more belt tightening, more work, and fewer of the tangible rewards for which people ordinarily work. To what extent the program will aid in relieving Britain's problems remains to be seen. For the laying of plans and the setting of targets is not all there is to it, as has been shown so often; plans have to be executed and targets achieved. One great question is the effect of more austerity upon incentives. If people find there is little or nothing they can buy for their extra hour's or day's labor, how keen will they be to put in that extra effort?

Analysis by London "Economist"

In the welter of talk and confusion of plans as to what ought to be done has come an impressive analysis by the influential London financial weekly — *The Economist.* Pointing to inflation as a root cause aggravating Britain's balance of payments troubles, this analysis calls for steps "to get the inflationary poison out of the national economic system."

The article, entitled "The Planners' Last Chance" appearing in the issue of August 2, begins by drawing a distinction between that part of the balance of payments problem for which Britain properly may be held responsible, and that part over which she has had no control, such as the rise in world prices, disappearance of overseas assets during the war, etc. It is roughly estimated that about half the balance of payments deficit is of the latter origin, but that "the other half of the deficit is of our own making. It originates either in the over-heavy political and military commitments the British people have undertaken, or else in the muddled and distorted state of our domestic economy."

The article points out that the trouble is by no means entirely due to insufficient production. True, there are sectors in the economy where that is manifestly the difficulty: notably coal and textiles. Also, an atmosphere of slackness is widespread. But certainly, the writer asserts, the aggregate output of goods and services is not low; on the contrary, it is high. National income, after adjustment for price changes, is higher than in 1938. Steel production, railway traffic, and consumption of gas and electricity are above – in some cases well above – prewar levels. Even the consumption of coal in England – as distinct from its production – is no lower than it was before the war. "There is really very little room for doubt," the writer concludes, "that the aggregate output of the British community today is from 10 to 20 per cent higher in volume than it was in 1938."

But consider the burdens being placed upon this productive output. The following, says *The Economist*, "is not even a complete list of the programmes and policies that have been set on foot by the unanimous agreement of the whole British people":

> The further increase of a standard of consumption which, in the aggregate and on the average, was, in 1946, already as high as in 1938.
>
> In particular, the maintenance of a standard of nutrition which – whatever it may be for the average of the whole people – is definitely higher than prevailed before the war for fully half the people. In the face of world shortage of food, high consumption is encouraged by subsidies.
>
> Creation of a national health service and the extension of the national educational system.
>
> A considerable extension of social insurance.
>
> The creation and full employment of a building industry larger than ever before.
>
> Repair of war damage and overtaking of wartime arrears of maintenance.
>
> Re-equipment of several major industries.
>
> An export programme of 175 per cent of the prewar volume.
>
> Servicing of a vast war debt.
>
> A large colonial development and welfare programme.
>
> Maintenance of peacetime armed forces at least twice as large as ever before.
>
> Acceptance of responsibility for a large slice of Germany.

Is it any wonder, the article declares, that the national output, large though it is, is too small for the tasks that have been set it? Is it any wonder that, even with the output index at 110 or 120 per cent of what it was in 1938, there is universal evidence of shortage?

How Inflation Works

Continuing its analysis, *The Economist* describes how these inflationary pressures work through the economy and throw the balance of international payments out of kilter:

> What is basically wrong with the British economy at the moment is that, as a nation, we are trying to consume much more than we produce. We do not, of course, succeed in doing so – except to the extent that we are borrowing from foreign countries or using up our working capital – but, in the effort to do so, untold harm is done. Like a flash of lightning seeking to complete its circuit to the earth, the great spending potential forces its way down every channel that is open to it, consuming all that stands in its way. Scarce goods and materials are sucked out of the working capital of industry. Every service industry that can increase its output with little use of materials is vastly over-expanded, so that labour is drawn into football pools and the like and away from more essential industries. The trade unions exploit the shortage of labour to extort more pay for less work, so that the very fact that the supply of goods is below the demand for them leads to a further restriction of supply. The Government – to change the metaphor from fire to water – overdrives its administrative machine in the effort to dam the flood and prevent it from swamping the supplies of really vital materials such as fuel and dollars. But yet it overflows.
>
> In this country, as Keynes once pointed out, it is the poor who consume the imports, and with the income of the wage-earners higher than it has ever been before, it is quite inevitable that imports, for all the controls, should be higher than they would otherwise be. It is also quite inevitable that the lack of incentives for either employer or wage-earner and the tremendous suction applied by the domestic market should make exports, for all the controls and for all the patriotic appeals, lower than they would otherwise be.
>
> It is inflation that makes it impossible for the miner to spend his wage, and it is inflation that deprives him of all apprehension of any retribution for slackness. It is therefore inflation that is responsible for the shortage of coal.

The conclusion of *The Economist* is that the nation must form a realistic estimate of what the community can produce, how much must be retained for vitally essential capital improvements, allow for exports and imports, and then by appropriate wage and fiscal policies see to it that the people do not have for spending and consumption more than is enough to absorb the remainder. In other words, a program of cutting the coat to fit the cloth.

The Economist has no illusions that it will be easy or popular. But, warns the editor, "unless the planners make haste to plan for realism, the blind forces of economic nature will take over – either because something snaps and the people revolt against controls, or through the massive growth of black markets. It is the planners' last chance."

Experience Elsewhere

The situation in Britain, as set forth above, is but part of the great inflationary problem of most European countries and of the world. Balance of payments trouble has always been a traditional symptom of inflation, as excess purchasing power tends, first, to monopolize the home market at

rising prices to the detriment of exports, and, secondly, to overflow into foreign markets with resultant expansion of imports. Of all this we have a further example in the following from the June "Index" published by the Svenska Handelsbanken, one of the leading Swedish banks:

> The economic situation in Sweden continues to be characterized by extreme boom conditions and by an ever-increasing inflationary pressure. While the production in Swedish industry is severely limited by an acute shortage of manpower and by lack of fuel and certain essential raw materials, the volume of disposable income has been considerably increased during the last half-year owing both to the abolition of the sales tax as from the beginning of the year and to substantial wage and salary increases.
>
> The widening inflationary gap and the pressure of consumer purchasing power have entailed a serious deterioration of the balance of trade, imports being stimulated and part of the goods normally exported being retained for domestic consumption. This in turn has led to a heavy outflow of foreign exchange from the Riksbank on such a scale that it cannot be allowed to continue without seriously impairing the country's international liquidity.

In contrast with these acccunts of the situation in Britain and Sweden, it is instructive to note a recent statement by Maurice Frere, Governor of the Belgian National Bank, on the exchange situation of that country. Addressing the annual shareholders meeting of that Bank, M. Frere is reported in a New York Times press despatch of August 25 as having spoken to the following effect:

> Mr. Frere said there was no reason to fear a dollar shortage for Belgian needs inasmuch as the National Bank's hard currency and gold reserves had been increased by 4,500,000,000 Belgian francs since last January and were still growing. The total gold reserves are 28,500,000,000 Belgian francs, he said.
>
> The banker praised the country's normal economic development since the liberation, attributing it to an insistent avoidance of any inflationary policy and a lack of capital investments by means of notes or artificial credits.

The Belgian experience shows the results of sound policies courageously applied.

August Budget Review

On August 20 the President released his midyear review of the federal budget for the current fiscal year ending June 30, 1948. This review is designed to summarize changes in the outlook for government receipts and expenditures since the original budget was presented to Congress last January. Compared with a nominal surplus of $200 million then anticipated, the President states that a surplus of $4.7 billion is now indicated on the basis of current tax rates and without allowance for possible additions to the international aid program. The estimate for budget receipts is now put at $41.7 billion, expenditures at $37 billion.

The rise in the expected surplus is the product of a number of divergent influences. The decision to continue the excise taxes at their wartime rates added $1.2 billion to the surplus; higher than anticipated levels of individual incomes and corporation earnings add $2.3 billion; and reductions in expenditures through Congressional action are figured at $2.6 billion.

On the other side of the ledger are net additions to fiscal 1948 expenditures through recommendations made by the President, put at $638 million, and an increase of $500 million in the estimated drawings by the United Kingdom on their credit. Among the President's new proposals, Congress accepted the $400 million proposed for Greek-Turkish aid, but scaled down or rejected a number of other requests for outlays over and above those which the President had proposed in January. Increases in expenditures initiated by Congress are put at $309 million, but the greater part of this results simply from a change in method of handling the Maritime Commission accounts which swells both the revenue and expenditure totals.

The President also calculated that $832 million of the Congressional cuts will be restored. In all, the President's revised expenditure totals assume that Congress, at the session beginning in January, will approve supplemental apropriations and grant new contract authorizations up to a total of $1,568 million and that $1,170 million will be spent under such legislation.

As shown in the following table, drawn from the President's budget review, the international affairs and finance item has grown from $3,510 million estimated in January to $4,301 million. The social welfare, health, and security heading shows a rise of $299 million, mostly accounted for by a shift into fiscal 1948 of expenditures which were to have been made in fiscal 1947. The figure for veterans' services and benefits is raised $126 million to $7,469 million, one-fifth of the expenditure total.

The decreases generally reflect Congressional efforts to compress government expenditures to a level which will permit tax relief, though special factors enter into many of the changes. The total for national defense, now $10,401 million, is cut $855 million, about two-thirds of which is attributed to Congressional action. The estimate for agriculture and agricultural resources is reduced $442 million, while the housing item is cut $375 million, chiefly from the elimination by Congress of the Reconstruction Finance Cor-

Budget Receipts and Expenditures
Based on existing and proposed legislation for the fiscal years 1947 and 1948
(In Millions)

	1947 Actual	1948 Estimated Budget Jan., 1947	1948 Estimated Revision Aug., 1947
Budget Receipts	$43,259	$37,730	$41,667
Budget Expenditures:			
National defense	14,451	11,256	10,401
Veterans' services & benefits	7,373	7,343	7,469
International affairs and finance	6,669	3,510	4,301
Social welfare, health & security	1,356	1,654	1,953
Housing & community facilities	385	539	164
Education & general research	71	88	72
Agriculture and agr. resources	1,331	1,381	939
Natural resources not primarily agricultural	578	1,101	1,160
Transportation & communication	861	1,530	1,435
Finance, commerce, & industry	237	426	297
Labor	121	118	102
General government	1,375	1,492	1,494
Interest on the public debt	4,957	5,000	5,125
Refunds of receipts	3,056	2,065	2,063
Reserve for contingencies	—	25	25
Adjustment to daily Treasury statement basis	—316	—	—
Total Budget Expenditures	$42,505	$37,528	$37,000
Surplus	754	202	4,667

poration authority to purchase veterans' housing mortgages and to make real estate loans which the Congress believed was encouraging loose lending.

How close these enormous totals will come to the mark when the books are finally closed on June 30 of next year is impossible to say. Likewise the figure $1,520 million *net* savings which the President chalks up to the credit of Congressional action must be taken as a tentative approximation. This amount might be increased by Congressional studies now under way on the operations of major government departments, by winnowing out the wheat from the chaff in considering requests for supplemental and deficiency appropriations, and by rescinding appropriations already made which appear excessive. To follow up along these lines is the announced intention of Congressional leaders.

A further task of the Congressional Appropriations Committees will be to review requests for funds covering the new fiscal year which begins July 1, 1948. Here the experience gained in connection with the 1947 appropriations can be invaluable in finding where further savings may be made without endangering the national security or essential peacetime services of government. The President has already made a helpful start by instructing the executive departments and agencies to hold their budget requests for fiscal 1949 below the 1948 totals.

September Treasury Financing

On August 20 the Treasury Department revealed the terms upon which the $6,735 million certificates and notes coming due in September would be refunded. The holders of $2,341 million ⅞ per cent certificates of indebtedness falling due September 1 are being offered in exchange similar ⅞ per cent certificates maturing July 1, 1948, ten months hence. Holders of $2,707 million 1½ per cent notes and $1,687 million 1¼ per cent notes, both of which issues fall due September 15, will be offered in exchange 12½ month 1 per cent Treasury notes. While holders of the notes will be asked to take a considerable loss in income, the terms of the new note offering were quite generally interpreted as raising the "pattern" rate at which the Treasury borrows one-year money from the previous ⅞ per cent to 1 per cent.

In keeping with the Treasury action and the gradually firming tendencies in the money market, a number of the leading New York banks last month adjusted their lending rates on collateral loans and buying rates on bankers' acceptances. The rate on dealer loans secured by short-term government securities was raised from ⅞ per cent to 1 per cent. Buying rates for bankers' acceptances maturing in ninety days or less were advanced from ⅞ per cent to 1 per cent, and new rates of 1⅛ and 1¼ per cent were fixed for those longer-dated.

Except for government securities coming due within 10 months, mainly bills and certificates, 1 per cent substantially has become the minimum in the structure of open market money rates.

Continuation of a Trend

These latest rate adjustments represent a further creeping advance in interest rates which began nearly a year and a half ago when the Federal Reserve Banks withdrew their special ½ per cent discount rate on advances secured by short-term government securities and made their regular 1 per cent rate applicable to such advances. The rate adjustments also reflect a response to the natural forces of the market tending to narrow the wide disparity between the rates under 1 per cent that have prevailed on short-term government securities and the rates of 2 to 2½ per cent on those of longer terms.

Maintenance of the prices heretofore prevailing for Treasury bills and certificates has required the Federal Reserve to stand continuously ready to support them. Supporting purchases in the two months just past, for example, have run between $400 and $500 million. These Federal Reserve purchases add to the supply of bank reserves and, together with the gains to reserves from foreign sales of gold, provide the banks with funds to bid for intermediate and longer-term bonds held by nonbank investors. This has the effect of "monetizing public debt," and creating inflationary pressures.

The Treasury and Federal Reserve authorities have sought to meet this problem by removing the fixed ⅜ per cent peg on Treasury bills, a step that was taken in July, and laying the basis for a more attractive rate on one-year money by shortening, from twelve months to eleven, the maturity on the ⅞ per cent certificate offered August 1. The further shortening of maturity, from eleven months to ten, on the ⅞ per cent certificate offered September 1, and the 1 per cent rate put on the new twelve and one-half month notes, represent a logical continuation of the moves made earlier in the Summer.

While Treasury bills and certificates still require support, at levels of ¾ per cent and ⅞ per cent respectively, prices of longer-term government bonds traded in on the open market have displayed a persistent buoyancy. The fresh upsurge that followed the announcement of the Treasury's September refunding plans suggested to many observers that the revision in the rates offered on short-term Governments was not proceeding fast and far enough to discourage the tendency of investors to shift from short-term to longer-term obligations. The longest term bonds eligible for bank investment reached the highest levels of the year during the week following the Treasury announcement.

New 2½ Per Cent Bond Offering

In conjunction with the disclosure of the September refunding plans, the Treasury made a preliminary announcement that a 2½ per cent non-marketable bond, dated October 1, would be offered the latter part of September. Subscriptions, limited in accordance with a formula to be revealed later, will be solicited primarily from savings institutions, insurance companies, and pension funds. The offering will help to meet the investment requirements of such classes of investors, and at the same time supplement Treasury resources available for the redemption of armed forces leave bonds or other securities coming due. It conforms to the sound principle of using every opportunity to fund the floating bank-held debt into longer-term bonds in the hands of investors.

Economics of Indian Partition

The transfer on August 15 of sovereign powers from the British Crown to the newly-created Indian Dominions — the Hindu state of the Indian Union, and the Moslem state of Pakistan — was a turning point in history, the political and economic significance of which is yet to be fully realized. Although independence has settled the problem of Anglo-Indian relations, which overshadowed other problems, it has created many new and complex difficulties. During two hundred years of British rule, India grew into a successful economic unit. Today, even without confusion and violence, the splitting up of this unit will call for difficult readjustments in both parts.

The two Dominions are not unlike business partners who, after a lifetime of common endeavor, have agreed to separate and are dividing their business. Many commissions and committees of experts have been set up to deal with the details of actual partitioning. The start was made by dividing the defense forces and administrative personnel. Partition of railway and of telegraph and telephone systems, now organized on an all-India basis, creates special difficulty, because both the Indian Union and Pakistan consist of two parts that are not contiguous.

Arrangements will have to be made, for example, for the two sections of Pakistan to have their through telephone and telegraph lines, and to run their trains over some 1000 miles of Hindustan (Indian Union) territory that separate them. Similarly, the Indian Union, to have access to eastern Assam, will have to use the railways and communication facilities of eastern Pakistan. Provision will have to be made for irrigation systems and electric power grids which overlap the new boundaries. Another involved and delicate problem will be the division of national and provincial debts, and the apportioning of gold and dollar assets as well as the £1.1 billion of sterling balances in London. A common currency will be used for the time being, but after April 1, 1948 Pakistan is expected to have its own notes and coinage.

Map of India Showing Approximate Boundaries of Two New Dominions

New Economic Frontiers

Economically, the new frontiers will divide India much as the Austro-Hungarian Empire was divided nearly thirty years ago. A part of the huge internal trade, which flowed among various sections of India and contributed so much to her economic self-sufficiency, will be "foreign" trade, subject to controls and tariff barriers. Long-established trade channels will be disrupted, and for a time the exchange of goods may be curtailed, to the detriment of both parts. It remains to be seen to what extent the energy and zeal, which both the Hindus and Moslems bring to the development and modernization of their two countries, can overcome the economic handicaps of separation.

Different parts of India, which like the United States is actually a sub-continent, have been unevenly developed economically. The great irrigation and hydro-electric power projects, located chiefly in Pakistan, were made possible only by a diversion of the centrally collected taxes from the richer and more advanced provinces such as Bombay. Pakistan alone could not have built these projects any more than our Pacific Northwestern States could have built Bonneville and Grand Coulee out of their own resources. Unless Pakistan has access to foreign capital or permits Hindu capital to continue to develop its resources, progress in bringing more land under cultivation by irrigation will be retarded. This, in view of the rapidly expanding population and consequent need of more food, would injure both the Indian Union and Pakistan.

Partition will also mean difficulties for the jute cultivators and the burlap industry, which normally are responsible for the creation of a large part of India's foreign exchange earnings. Most of the jute growing districts are in eastern Pakistan. On the other hand, Calcutta, with its jute processing mills, shipping facilities, and business houses specializing in jute and burlap trade, remains in the Indian Union. Both Dominions will want to share in foreign exchange earnings. The prospects are for a double set of export controls and possibly export duties also. How the problem will be settled without some injury to cultivators and to the mills is difficult to foresee.

Drawings of new frontiers will probably affect also the Indian cotton textile industry. Uneconomic duplication will occur if Pakistan insists on developing its own cotton mills.

Economics of the New States

An idea of the economic resources of the two new Dominions can be had from the table below. The data, apparently based on prewar figures and subject to some revision, were taken from a pamphlet recently prepared by G. D. Birla, prominent Indian industrialist.

Resources of Indian Dominions

	Indian Union	Pakistan
Agricultural Resources		
Jute (thousand acres)	984	1,404
Cotton (thousand acres)	13,770	1,630
Tea (thousands acres)	641	97
Rice (thousand tons)	17,229	5,376
Wheat (thousand tons)	4,200	2,785
Sugar (thousand tons)	2,631	517
Peanuts (thousand tons)	2,274	—
Mineral Resources		
Coal (thousand tons)	25,080	198
Petroleum (thousand gallons)	65,969	21,113
Chromite (thousand tons)	5	22
Copper ore (thousand tons)	288	—
Manganese ore (thousand tons)	766	—
Magnesite (thousand tons)	23	—
Mica (thousand cwt.)	109	—
Industrial Plants — number		
Cotton mills	380	9
Jute mills	108	—
Sugar mills	156	10
Iron and steel mills	18	—
Cement factories	16	3
Paper mills	16	—
Glass works	77	2
Other		
Railway mileage (thousand miles)	26	15
Potential water power (thousand kw.)	1,343	2,847

The Indian Union is economically by far the stronger and more advanced of the two Dominions. With a population more than twice that of the United States and with most of the mineral resources, particularly huge coal and iron deposits, it has many of the elements necessary for the making of a great industrial nation. It retains more than 90 per cent of the industrial capacity of the old India, including the huge Tata Iron and Steel Works, and most of the new industries, such as chemicals, developed during the war. Its share of the old India's national income and government revenues will likewise be far greater than its 75 per cent share of population would indicate. It will retain also most of the capital resources. On the other hand, although still overwhelmingly an agricultural country, the Indian Union will have a bigger food deficit than before, and for this reason will be dependent upon Pakistan's surpluses of wheat, rice, and other farm products.

Pakistan, together with the Native States and the frontier areas, is estimated to have a population of around 100 million, making it the largest Moslem country in the world. Economically the two parts of Pakistan are very different from each other. The western section is based largely on wheat and cotton cultivation. The eastern section, now called Bangistan, depends chiefly on jute, rice and tobacco. Both sections will be vulnerable to weather and world prices for their cash crops; as the *Eastern Economist* observes, their budgets are likely to become an annual gamble in rains.

For a long time, therefore, the two sections of Pakistan will be far more dependent economi-

cally upon the Indian Union than upon each other. Industrialization will require outside capital to develop coal and petroleum deposits, and the potentially great water power resources.

United States Trade Prospects

Apart from a certain amount of confusion and uncertainty, as illustrated by the situation in jute and burlap, no immediate drastic changes in American trade with India seem likely to occur. The economic controls now in force will remain identical in the two Dominions until March 1, 1948 when the present standstill agreements expire. There is to be no interference with passenger travel and the flow of internal trade during the next six months. Import regulations of the Indian Union and Pakistan are to remain unchanged to March 1, 1948. From now on, applications for import licenses will have to specify the port of entry.

The bulk of American trade will be with the Indian Union, but this does not mean that our trade with Pakistan will be unimportant. Our leading imports from Pakistan will be jute, followed by carpet wool, carpets, goat skins, cashmere goat hair, bristles, and various inedible animal products.

The partition of India comes at the time when trade between the United States and India is breaking all records. Since the war, India has turned to us for foodstuffs and for capital goods and other industrial products such as motor vehicles, machinery, and electrical appliances. In turn, we, in the absence of European specialties, are buying from India more craft wares, such as silks, brocades, carpets, and brassware. The principal products traded betwen India and the United States in 1938 and 1946 are listed in the accompanying table.

United States Trade with India
(In Millions of Dollars)

	1938	1946
Principal Imports from India		
Jute and manufactures	$31.2	$ 91.6
Shellac and lac	2.0	19.1
Cashew nuts	3.5	16.8
Tea	3.4	16.5
Hides and skins, raw	3.8	15.5
Raw cotton and cotton waste	2.1	15.2
Wool, chiefly carpet wool	2.8	9.6
Leather	.4	9.0
Undressed furs	1.0	8.0
Mica	.5	5.0
All others	7.3	31.4
Total	58.0	237.7
Principal Exports to India*		
Wheat and bread grains	—	58.5
Other foodstuffs	.7	15.3
Chemicals	3.5	18.2
Machinery	6.7	13.0
Tobacco, unmanufactured	1.8	9.7
Metals and manufactures	3.1	6.5
Petroleum and products	2.9	6.2
Textiles	.8	5.5
Raw cotton	2.9	—
All others	11.0	36.4
Total	33.4	169.3

*Cash exports only, excluding lend-lease and relief shipments.

The 1946 record figures for both exports and imports would be easily surpassed this year except for the tightening of import allocations announced by the Indian Interim Government in June. On the basis of the first six months of 1947, our imports from India were at the annual rate of about $250 million, or somewhat more than in 1946; exports to India were at the unprecedented rate of over $450 million, or more than twice that of 1946 and thirteen times prewar. Our normal import balance on trade with India has given way to a large export surplus, amounting in the first six months of 1947 to around $110 million.

In contrast with the situation during the war when India contributed heavily to the sterling area dollar pool as a result of surpluses in her cash transactions with the United States, India in the past year has had to draw on the dollar pool in order to finance her trade deficit with us. The eventual winding up of the sterling area dollar pool arrangements may mean therefore a reduction of Indian purchases here unless other means of financing the trade deficit are provided. Improvement in Indian food output would release considerable dollar funds now used for food imports, thus permitting the heavy imports of essential capital goods to continue.

India's attainment of independence by agreement reflects credit upon the statesmanship of the representatives of the Indian and British people. It is an achievement that engenders hope at a time when the world is sorely tried by the disunity and disorder that have followed the war. It is to be hoped that the same high statesmanship which has been shown in setting up the framework of independence can be applied to the manifold further problems, both political and economic, that will have to be worked out if independence is to mean continued progress in the welfare of the Indian people.